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# WHAT ARE PATRONAGE REFUNDS?

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# Preface

Kelsey B. Gardner, then Director, Management Services Division, Farmer Cooperative Service, U. S. Department of Agriculture, gave a talk on Patronage Refunds and the Cooperative Concept at the annual meeting of the National Society of Accountants for Cooperatives in Indianapolis, Ind., September 21, 1961.

Mr. Gardner has since retired. We are issuing this publication based on this talk because of its general importance to farmer cooperatives. Mr. Gardner's clear evaluation of the patronage refund concept in cooperative operations is based on long years of experience in the cooperative financing field.

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# What Are Patronage Refunds?

by Kelsey B. Gardner

Cooperative language has numerous terms which are either inadequate or cannot be given all-inclusive use. "Patronage refunds" and "cooperative concept" are cases in point. Most of us have an inadequate concept of these terms. Thus, to gain a clearer understanding of them, we can start by defining them and then discussing some of the numerous facets of each.

For a definition of patronage refund, let us turn to a statement of Marvin A. Schaars, University of Wisconsin:[1]

"The terms 'patronage refund' and 'patronage dividend' are inappropriate terms. Only in purchasing and service companies where original deposits or payments have been made in excess of the cost of merchandise plus operating expenses or cost of providing the service can we logically speak of re-

[1]Abrahamsen, Martin A., and Scroggs, Claud L. Agricultural Cooperation: Selected Readings, 1957. pp. 192-3. (The quotation is from a talk by Mr. Schaars at the Extension Educational Workshop, American Institute of Cooperation, Utah State Agricultural College, on August 31, 1951.)

funds. The term 'dividend' in standard usage connotes profits, which a true cooperative, of course, does not have.

"In a marketing association, the successive payments made for products in addition to the original payment are fundamentally price adjustments and are neither refunds nor dividends. This is the case whether such additional payments or only a single final payment is made possible because of better than anticipated sales prices received by the cooperative or whether the operating costs proved to be less per unit of product than predicted.

"In a purchasing or service association, I like to think of the original payment made by the member as a deposit, subject to adjustment when the precise costs are determined at the close of the accounting period.

"In a marketing association, the first payment made to the patron is a price advance, from an economic standpoint, also subject to final determination at the close of the pool period or accounting period.

"Thus, although we use the term 'patronage refund' because of its common usage and widespread understanding, we do so with the limitations indicated above."

Patronage refunds do not have an all-inclusive, across-the-board application even in the rather restricted field of farmer marketing cooperatives.

For example, in a grain association, where the amount of a net margin is determined at the close of a fiscal period, distribution to patrons according to a legally-binding contract may properly be referred to as a patronage refund.

On the other hand, in a citrus cooperative operating on a pooling basis, the term "patronage refund" may well have no application or reason for use, since the financial benefits are incorporated directly in sales returns, and there is no recognized patronage refund.

Before going further, let us look briefly at the genesis of the idea of the patronage refund insofar as it is known. J. A. Hough[2] states that "It is a moot point, whether or not the Rochdale Pioneers were the first to discover, or even apply, the principle of dividend on purchases in cooperative enterprise..." The author points out that cooperatives had probably been formed 60 to 70 years before Rochdale's 1844 date.

He believes, however, that in the majority of these associations "profits," as he labels them, were distributed in proportion to capital investment. The Rochdale Pioneers in their "Laws and Objects" provided that "Interest at the rate of 3-1/2

[2]Hough, J. A. Dividend on Co-operative Purchases -- A study of dividend on purchases as an element in co-operative trading with special reference to the British consumer's co-operative movement, Co-operative Union, Ltd., Manchester, England. 1936.

percent per annum shall be paid upon all shares paid up previous to the quarter's commencement; the remaining profit shall be paid to each member in proportion to the amount of money expended at the store."

The idea behind this clause is of the utmost significance to cooperatives whose operating techniques include determination and distribution of patronage refunds.

## Cooperative Concept Discussed

The other term "Cooperative Concept" also calls for some clarification. In a broad sense it evolves from basic viewpoints in the United States and Canada relating to voluntary association in cooperative organizations set up to meet essential needs of members. A good, workable definition of a farmer cooperative is presented in the first paragraph of FCS Bulletin 10, Legal Phases of Farmer Cooperatives. This reads:[3]

"An agricultural cooperative is a business organization, usually incorporated, owned and controlled by member agricultural producers, which operates for the mutual benefit of its members or stockholders, as producers or patrons, on a cost basis after allowing for the expenses of operation and maintenance and any other authorized deductions for expansion and necessary reserves."

[3] Farmer Cooperative Service, U.S. Dept. of Agr. Legal Phases of Farmer Cooperatives. Bul. 10. 1957.

This statement is followed by these additional words that apply to this discussion:

"The principle of doing business on a 'cost basis' involves these concepts: (1) that the contract between a properly organized cooperative and its patrons vests the excess between its receipts and expenditures during an accounting period in its patrons, and (2) that, accordingly, a cooperative, as a legal entity, cannot have entrepreneur profit as respects any excess which is covered by such contract. This is in contrast to the status of this excess in the usual business corporation."

It should be quickly added that many people outside cooperative circles apparently do not accept the thesis that "a cooperative, as a legal entity, cannot have entrepreneur profit as respects any excess which is covered by such contract."

Three principles support the above cooperative concept, and comprise its foundations. They are:

1. Democratic control.
2. Service at cost.
3. Limited return on invested capital.

What are the impacts of patronage refunds on these three concepts? What is the relation of patronage refunds to them?

## Democratic Control

The adoption by many cooperatives of the one-member one-vote principle regardless of the amount each member has invested undoubtedly reflects the concept of distributing financial benefits according to patronage rather than according to the size of each individual's investment in the cooperative.

Other factors contribute, of course, but emphasis on distribution of benefits from cooperation on a patronage basis rather than primarily as a return on investment undoubtedly contributes to the widespread adoption of the one-man one-vote principle. It is true that there are some significant departures in farmer cooperatives in the United States from the one-man one-vote principle. However, the general acceptance and adoption of the one-man one-vote principle reflect the patronage benefit concept rather than earnings on investment.

## Service at Cost

If there is any one basic principle in cooperation, it is service at cost for member-patrons. From it arises the fundamental cooperative concept of savings as contrasted to profits in the usual business enterprise. Unfortunately, the belief of cooperators that net margins, allocated and distributed in accord with a legally-binding contractual obligation are not income to the cooperative is not unanimously agreed to by some of these outside cooperatives.

It is not unusual to be confronted by statements that there is no distinction between income produced by one form of business organization and that produced by any other form; and that income produced on capital, whether owned or used by a person, cooperative, or any other enterprise, is income to the organization producing the income.

Such statements clearly reveal a failure on the part of their makers to understand cooperatives. They fail to recognize such distinctively cooperative characteristics as those relating to individual ownership of capital in cooperatives and to proportionate sharing by patrons of the financial benefits of cooperatives through legally-binding contractual arrangements.

Many people do not understand that cooperatives are basically different than other business organizations in at least one unique and important respect; that is that services are performed for those who at the same time are owners, members, and patrons.

This situation stems directly from failure to recognize the true nature of the sharing of financial and other benefits in proportion to each individual's use of the services available through an association. This practice has no counterpart in other business enterprises.

In a more restricted sense, these people fail to recognize the nature of

the patronage refund. This points directly to the need for definitive research on the economic nature of the patronage refund. It points to the imperative necessity for cooperatives to conduct educational programs that make clear the economics of cooperation not only to their members but also to outsiders.

As previously stated, some individuals take the position that amounts remaining after payment of expenses are profits belonging to the owners of the business in their capacities as owners. Patron-sharing of financial and other benefits has no place in this doctrine.

Marvin A. Schaars[4] has appropriately stated some important considerations on this point: "The principle of 'service at cost' recognizes the agency relationship of the cooperative to its member-patrons. Even though the cooperative may be incorporated, and, therefore, have a legal standing separate and distinct from its members, this corporate existence does not invalidate the basic economic relationship of the cooperative to its separate members. It is still the agent of its members and integrates the functions of the cooperative with those of its members in their separate capacities as producers or consumers. It is not

[4] Abrahamsen, Martin A., and Scroggs, Claud L. Agricultural Cooperation: Selected Readings, 1957. pp. 191-2. (The quotation is from a talk by Mr. Schaars at the Extension Educational Workshop, American Institute of Cooperation, Utah State Agricultural College, on August 31, 1951.)

designed to profit on the services rendered for its members but to provide these at cost. The cooperative as a corporate entity, is, therefore, nonprofit in character."

Cooperative accountants, membership workers, and information people have their job cut out for them. They must help bring about more widespread understanding of the fact that cooperative benefits, including patronage refunds, are not economic profits to the cooperative corporation.

Correct terminology and well-prepared annual reports can be major tools to get part of this job done. The cooperative concept of savings must gain more extensive understanding and acceptance, if the economic nature of farmer cooperatives is to be adequately understood.

## Limited Return on Investment

The patronage refund principle exerts a significant impact within cooperatives on the rates of interest or dividends paid to members on their invested capital. This stems from the basic concept that financial benefits should be shared in proportion to the individual patron's use of the association's services, rather than on his capital investment.

The result is that a member's return on capital invested in cooperatives has two distinct and separate aspects. The first is the stated rate of return on his capital. This rate is generally

set on an interest basis. This concept is in direct contrast to the dividend in the usual business enterprise which is a share in earnings. The second and more important aspect of his return on invested capital is reflected in his patronage refunds or other benefits resulting in part from use of capital in furnishing services available through the association.

## Relation of Refunds to Cooperative Concept

A number of additional comments may well be made on the relation of patronage refunds to the cooperative concept:

1. Patronage refunds are the primary source of member capital in farmer cooperatives.[5] A study by Farmer Cooperative Service revealed that about 61 percent of the equity capital in the sample of 1,157 marketing and purchasing associations came from retained refunds.

These retained amounts varied in proportion to the members' use of the services of each cooperative. Their retention as allocations based on use and their nonrelation to member-patron investments prevented the shares or other equity certificates of cooperatives from participation in growth.

[5]Hulbert, H. H., Griffin, Nelda, and Gardner, Kelsey B. Methods of Financing Farmer Cooperatives. Farmer Cooperative Service, U. S. Dept. of Agr. General Report 32. 1958. Page 14.

The extent to which patronage refund amounts may be diverted to so-called "free surplus" or to higher returns on capital reduces the amount of financial benefits to be shared in proportion to the use of an association's services. To direct funds in this manner would conflict directly which the cooperative concept because its effect would be to bolster the investment aspects of an association by increasing their significance from the standpoint of rates of return.

2. Another phase of the patronage refund-cooperative concept relationship deals with the extent to which patrons look to the rate of refund as the sole reason for patronizing the association. One of my colleagues tells of the Britisher who, when asked to state the success of his cooperative, replied, "It's the 'divvy'!"

To my way of thinking, such complete reliance on patronage refunds as a basis for maintenance of member participation and support misses the boat. Patronage refunds cannot be the sole measure of cooperative effectiveness.

Directly related are the association's pricing policy and costs of operation. I would be the last one to minimize too greatly the value of the refund as a partial measure of cooperative benefits. Services performed by cooperatives, however, are of benefit even though they cannot be measured by the patronage refund. Quality of products or advisory services to members are examples.

3. Patronage refunds are a source of misunderstanding to outsiders at times. This stems largely from failure to recognize the nature of the cooperative and the relation which exists between member and association.

From time to time a demand arises for marketing associations to set up an arbitrary margin based on costs of operation and competitive prices for members' products delivered to the association for sale. The purpose is to develop a theoretical "profit" figure. Agitation for this step came during World War II in connection with renegotiation procedures. Some income tax proposals have also reflected this idea. A better understanding of the nature of patronage refunds might well forestall such efforts.

4. Another problem lies in the area of the relation of patronage refunds to equity among patrons of a cooperative.

In some quarters there is a disposition to question the position that net margins of cooperatives on each article or service are not income to the cooperative because they are implicitly assumed to be distributed or allocated on a basis exactly proportionate to the total net margins on similar articles and services for the year. Those holding this point of view contend that overpayments are made on some articles or services and underpayments on others.

This point of view is mentioned only to emphasize that the job of explaining

cooperative concepts and the nature of patronage refunds is not yet done. It is essential that at least those who are in a position to make important decisions for cooperatives should understand these points. It goes without saying that wider understanding of cooperatives by the public generally will prove advantageous to both cooperatives and the public.

## Research Needed

The patronage refund area is one where there is a marked lack of research. Comments offered in this publication include references to fields where research might be helpful to farmer cooperatives.

This definitive research could help cooperators with organizational and operating policies and practices. It could help in membership and public relations programs. It could also assist those who are concerned with governmental policies relating to cooperatives.

As a beginning of this research, here are a few ideas:

1. An analysis of the economic nature of patronage refunds. The objective of such a study would be to answer conclusively the question of whether patronage refunds are profits from the economic point of view.

2. A clarification of what constitutes equity among members of a cooperative when determining amounts

of patronage refunds and their distribution to members.

3. A companion study would include an evaluation of the reasonableness, from the standpoint of equity and practicality, of cooperative methods for determining and allocating patronage refunds to individual members.

4. A closely related study would involve a search for the extent to which further departmentalization for patronage refund purposes is justified in farmer cooperatives from both practical and theoretical points of view.

5. Another research area involving patronage refunds and the cooperative concept might deal with policies to maintain uniform rates of refunds from year to year regardless of variations in actual net margins.

6. And we need to find the answer which presents the more equitable procedure in marketing cooperatives: (a) pooling sales returns, or (b) advances based on currently prevailing commodity prices combined with patronage refunds determined at the close of fiscal periods.

Distribution of financial benefits of cooperation in proportion to use of an association's services is a fundamental cooperative concept. Thinking needs to be stimulated about the nature of patronage refunds and the problems they present to cooperatives. Misunderstanding will be present as long

as some individuals continue to believe corporate profits and cooperative corporation savings are one and the same thing.

The job is cut out for cooperatives and those concerned with their progress. Successful steps must be taken to bring about proper understanding of the economic nature and objectives of farmer cooperatives with particular emphasis on the role of patronage refunds in member and public relations.

## Other Publications Available

Financing Farmer Cooperatives, Educational Circular 5.

Revolving Fund Method of Financing Farmer Cooperatives, General Report 41. Helim H. Hulbert, Nelda Griffin, and Kelsey B. Gardner.

Methods of Financing Farmer Cooperatives, General Report 32. Helim H. Hulbert, Nelda Griffin, and Kelsey B. Gardner.

Farmers' Equities in Their Marketing and Farm Supply Cooperatives 1954, General Report 27. Nelda Griffin, Helim H. Hulbert, and Kelsey B. Gardner.

What About Cooperative Financing? News for Farmer Cooperatives, April 1959.

How Farmers Finance Their Cooperatives. Reprint 145.

A copy of each of these publications may be obtained upon request while a supply is available from --

Information Division
Farmer Cooperative Service
U. S. Department of Agriculture
Washington 25, D. C.